

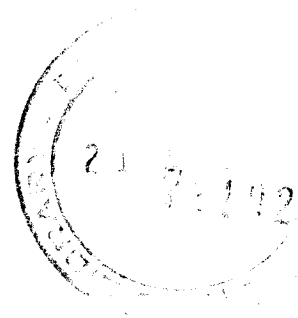
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Markets and Institutions in Developing Countries:
Implications for Economic Research

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Introduction

The basic problem for economic policy makers in LDC's in the 1980's, put simply, is to adapt their economies to survive and grow in the face of external shocks and internal pressures. External influences have been increasingly important over the last decade, and include oil price hikes, changes in terms of trade and technological innovation. The most obvious internal pressures are population growth and, in some cases, shortages of land and other rural resources.

The objective for policy makers should be to restructure their economies, exploiting their dynamic comparative advantage to provide greater quantities of goods and services to their populations from a combination of both domestic and foreign sources. This has to be done in such a way that basic needs continue to be met and the domestic resource base is not depleted. This is a difficult task and a more important one than ever before. In the 1960's and early 70's, policy makers tried to accelerate the rate of growth in their countries. Many countries in the eighties are simply trying to survive; they have to adjust as fast as they can just to keep from sliding back.

At this point in time, it is fairly safe to draw a broad picture of what a healthy, dynamic economy looks like. It should be flexible in order to adapt quickly and smoothly to external shocks. It should embody a mutually complementary relationship between agriculture and industry, rather than an exploitative one. It should be open to technological innovation and reasonably open to market signals.

These are relatively non-controversial observations, in part because they are so broad. A look at the experience of the S.E. Asian NIC's provides some more specific factors promoting successful economic performance and growth. Some of those are:

- the selective and facilitative role of the state in promoting industrialization, in contrast to the pattern of generalized protection found so often in Latin America or the phenomenon of industrial parastatals in Africa;
- the existence of an efficient bureaucracy to carry out that role;
- the implementation of land reform;

- the existence or creation of appropriate rural institutions to transmit technology, inputs, credit and other services to small farmers and to harness their savings and investment potential.

Research Problems for Policy Analysts

The exact nature of the end state towards which any developing country should move will vary greatly from case to case, depending among other things on domestic resource endowments. One of the basic contentions of this paper, however, is that the broad general characteristics of a viable economy are fairly clear and that what isn't clear is being intensively researched by a great many individuals and agencies. The marginal return to IDRC's limited funds would not be greatest from research on where developing countries should be heading. The research frontier lies not in defining where we're going but in suggesting how we get there from here. Assuming that economies need to adapt and restructure, how should they do it? How can countries effect fundamental changes in their economies?

On this subject, it is extremely difficult to find any research that will provide guidance. The IMF and the World Bank, the major international institutions prescribing policy reform, have little to say about this. For the most part, the IMF applies standard, simplified recipes; in part, it has to in order to be seen as treating each country impartially. For whatever reason, the IMF and World Bank recipes (e.g. the Berg Report) seem to me to be seriously flawed by what could be called the 'assumption of symmetry'.² This is the notion that all one has to do to get an economy moving is to remove various market imperfections that have been erected over the last two decades. This is something like spinning a wheel in one direction, then suddenly stopping it with a touch of a finger and spinning it in reverse. If I can mix metaphors, this always reminds me of the trick photography you sometimes see where a film is run in reverse. Objects fall from the floor to the ceiling; water runs uphill; a bullet pops out of the victim's heart, flies back into the gun and he (or the economy) springs back to life.

The problem is that real world political economies don't function that way. Their wheels don't instantaneously spin backwards, because they have built in ratchets. Wages and some prices tend to be downwardly rigid, public sector employment expands in boom periods but is difficult to reduce in recessions, and economic distortions create excess profits and privileged positions, the beneficiaries of which are very reluctant to give them up. A wide range of institutional and political factors, in short, impede rapid adjustment.

The IMF and the Bank have taken some tentative steps in this direction. The IMF has done some research on sequencing

(e.g. in liberalizing an economy, should interest rates be adjusted before, after, or at the same time as exchange rates?). The Bank has set up a Policy Analysis unit, but so far its mandate is very limited.

In view of the above, I suggest that the research frontier for economists lies in the investigation of how economic restructuring and policy reform can be effected. Policy analysts should be looking at the effects of change on specific income groups, at ways to minimize the costs of adjustment, at ways to compensate the losers, at the optimal rate and sequencing of adjustment. Above all they should take into account the institutional and political factors which may block reform. They should not assume that changes in macro prices will automatically be transmitted to economic agents, but investigate in both a descriptive and a prescriptive sense the institutional channels which mediate between prices and behaviour and which can serve a positive function in providing feedback to policy makers.

The Role of Economic Analysis in Addressing the Research Problem

I'll return to some of these research issues at more length later. At this point, I'd like to take a critical look at the discipline of economics and see how well suited it is to the research agenda I've briefly suggested. First, let me say that I think economic analysis can be a very powerful tool. In my own admittedly biased view, economic logic has a rigour and a clarity that other social sciences disciplines sometimes lack. I think that economists have generally not put their tools to good use, however.³

For one thing, they often apply their tools to problems only after they have made highly unrealistic or restrictive assumptions about the cases they are studying. The assumption that markets clear (that supply and demand will reach an equilibrium) entirely through price changes is more or less true in some markets and completely false in others. The labour market, for example, simply doesn't work this way. When unemployment goes up, we don't find people knocking on employers' doors offering their services for a dollar less than the going wage. If they do, we don't find employers accepting the offers. Institutional factors related to the effects of rapid turnover on motivation and on-the-job training lead to other means of clearing the labour market.

For another thing, neo-classical economics is not a dialectical discipline; its basic tool for studying change is comparative statics. That is, it compares two static situations separated in time, rather than examining the process of change itself. Among other things, this makes it difficult to distinguish causality from correlation and makes it a weak tool for suggesting means by which change can effectively be implemented.

Third, the profession currently exhibits an extraordinary concern with theoretical purity and elegance. Increasingly, the principal criterion for evaluating a piece of economic analysis is its internal logical consistency rather than the degree to which it describes, explains or predicts real world behaviour. A recent survey of the articles published in the American Economic Review provides an illustration. The survey found that 93% of the articles contained no data; they simply manipulated algebraic variables in equations or sets of equations according to assumptions chosen by the author. Another 6% analyzed data taken from secondary sources such as Federal Trade Commission statistics. Only 1% of the articles presented new data. I suggest that this is not the best way to further our understanding of how economies work.

Fourth, conventional economics is poor at dealing with such crucial factors as information, psychology and motivation. In order for economic analysis to work smoothly, the analyst must assume that everyone has perfect information (or the best information he can get) about prices and the availability of goods. He must also assume that individuals are motivated only by the desire to maximize profits or income and that goals such as meaningful work, human contact, and prestige are irrelevant. These are not realistic assumptions and close off crucial areas for investigation.

Fifth, the discipline is internally split along several dimensions. There are subdisciplines within a distinct pecking order (institutional, welfare and labour economics at the bottom, theoretical economics at the top). There is a gulf between macro and micro economists. And there are basic differences of opinion among the four major schools: neo-classical, Keynesian, monetarist and rational expectations. Some of these splits provoke fertile debates (such as that among the different schools of thought) but others, particularly the micro/macro split, are pernicious.

Sixth, economists tend to ignore the fact that the market is only one institution among many in which exchange takes place and that it operates within an institutional framework of property rights defined by the state and society. The institutions which supplement the market and the overriding rules of the game are specific to individual societies. For this reason, economic laws cannot be universal and cannot be abstracted from the study of specific economies.

Seventh, economists use their tools to look only at exchange that takes place within markets and not at the allocation of values by other institutions. In this sense, economics is both too modest and too brash. It refrains from investigating many aspects of human behaviour to which its tools could usefully be applied. At the same time, it pretends that the area it does explore is the universe and that economic policy can influence in a predictable fashion all important aspects of behaviour.

These deficiencies have led to some spectacular failures on the part of economists to predict important trends and events. The most conspicuous is the collapse of the Phillips Curve, the theory that there is a trade off between inflation and unemployment. Attempts by monetarists and the rational expectations school to modify the Phillips Curve have not been persuasive and the phenomenon of stagflation has caused a crisis of confidence in economic theory as a guide to policy. The failure of conventional economics in developed countries is serious enough; the transfer of a research approach which avoids empirical investigation to developing economies whose institutions are little-understood is even less promising.

Alternative Approach

In this section, I'll try to outline some alternative approaches to research on economic adaptation, ones which go beyond economic theory to provide a potentially more powerful analysis of the factors which promote and impede change.

The approach I'm going to describe has been variously labelled institutional economics, public choice, or political economy. It basically involves the examination by economists of non-market institutions which allocate resources. It recognizes that individuals maximize more than income or profits and that institutions vary from country to country. These institutions allow individuals access to power, prestige, followers, networks, travel, and other values which may not be available through markets. It also studies the role of institutions, customs and laws in defining the rules of the game within which market transactions take place. It requires a precise and detailed knowledge of local cultures, structures and institutional environments.

This method of analysis should supplement and not supplant conventional economic analysis. Changes in the environment, a food price increase for example, will provoke three types of response, each requiring a different type of analysis. The first is a straightforward supply response. *Ceteris paribus*, there should be a tendency for production to increase as price increases. The second is an institutional response: if all food production is carried out by women but all receipts go to the men, the structure of decision making within the household will influence the supply response. Third is the political response: food consumers may protest and get the price increase rolled back. The point is that all three types of response must be anticipated if an effective reform of food price policy is to be implemented.

The institutional analysis I'm proposing is of two types. The first is diagnostic and descriptive: the analysis of existing institutions and their effects on responses to policy or other sources of economic change. The second is positive

and prescriptive: the design of new institutions. As the S.E. Asian experience indicates, the existence of appropriate institutions to transmit price incentives and provide services to small farmers is an essential condition for rural development.

The discussion of institutions to this point may have been somewhat abstract. I'll try to make it more concrete by providing some examples of both types of institutional analysis.

The clearest example of the first type from developed countries is the operation of the labour market as I described it earlier.⁴ Unemployed workers simply do not bid themselves into jobs. Why not? The answer seems to be that the continuous personnel turnover this would create would lower morale and productivity. Furthermore, it would give senior workers no incentive to train junior workers since, once trained, the juniors would underbid their trainers and put them out of work. On the job training would be impossible. The employer's practice of refusing bids from the unemployed is not irrational or a 'market imperfection'; it is an entirely rational practice which enhances motivation and skills acquisition, two elements which conventional economics is poor at analyzing. Only recently have economists broadened their treatment of labour markets, looking at such phenomenon implicit contracts and internal markets.

In developing countries, similar examples can be cited. Research has shown that peasant producers are influenced not only by how much they are offered for their goods but also by whom and in what circumstances. Norms and social relations can determine whether a good is exchanged or sold, or affect the interest rate on a loan. Individuals may acquire resources such as land at prices they cannot afford because ownership of those resources brings with it prestige, political power and claims on the labour of others, including family. Apparently perverse responses to shifts in price ratios may be entirely rational when the purchase of one factor of production actually increases access to the other.

In understanding the logic of institutions, analysts must expand their definition of rationality. The structural reform of institutions like public enterprises or government ministries is often short circuited by the informal management system and pressures from outside.⁵ It is often in the interests of bureaucrats to maintain complicated procedures, red tape, departmentalism and so on in order to maintain control over information and preserve their power. A complicated system gives old timers and skilled manipulators power over clients and an advantage over newcomers. Institutional reform must therefore penetrate the informal logic at work behind the formal structure and provide concrete and consistent incentives for actors to modify their

behaviour. A few economists have begun to develop an 'economic theory of bureaucracy', though so far it has been applied mainly to developed countries.

At a more general level, it must be recognized that states plan their actions in accordance with a non-economic rationality that can supercede and impede economic efficiency. Marxists like Poulantzas contend that the state plays an autonomous role in resolving conflicts among dominant classes or within the dominant mode of production in order to preserve the capitalist system in the long run. It may, for example, apply price controls so that workers don't revolt; the result is a short term loss of profit for capitalists but a long term gain. Political rationality, in this view, reflects economic rationality and preserves economic efficiency.

The public choice school differs in proposing that political rationality can override economic rationality and at the expenses of efficiency. Robert Bates⁶ has pointed out the phenomenon common to Africa whereby governments encourage agricultural production through projects (involving subsidized inputs to project participants) at the same time that they discourage production through adverse pricing policies. The public choice explanation is that project benefits can be targetted and thus provide a source of coercion, patronage and control. Price policies have generalized effects and offer fewer political advantages. The result has been the stagnation of African agriculture, an outcome which is economically inefficient. Governments themselves suffer as the size of the pie from which they take their tax slice shrinks. In the extreme case, the short run interests of a coalition of interest groups can become a log jam which, until broken, will send a country like Ghana into a prolonged downward spiral.

Non-economic rationality can have either beneficial or harmful effects, depending on the case. The labour market example is one in which extra-economic rationality leads to better worker motivation and transfer of skills. A variety of conventions and customs like the essentially voluntary obedience of traffic laws is a similar example of a cooperative non-market solution to a problem. The African example I just cited is a pathological case.

The second type of institutional analysis to which I referred is the search for alternative institutions to promote change and rural development. The use of local public finance to build schools and roads, or to pay for agricultural extension is a promising development which could relieve the financial burden on central governments and give local communities more control over the services they receive. The degree to which such institutions respond to the needs of the poorest, rather than to those of local elites, as well as the efficiency with which they discharge their responsibilities all deserve investigation, however. New institutions which could

complement technological innovations, transmit incentives, motivate local people, harness their savings and investment potential and provide feedback to central governments have a potentially enormous role to play in promoting rural development.

This second type of analysis - the study of institutional innovation - is the one which our program has developed furthest. The most important area is that of rural resource management in Asia. Governments, communities and researchers are trying to devise ways of allocating property rights and managing the use of land, water and forests to permit equitable access by the poor and preserve the resource base. The work we have begun to support on contract farming tries to specify the appropriate conditions for a system which holds great promise in providing small farmers with price stabilization, technical assistance, and other services. The work on small scale fisheries and handicrafts also devotes some attention to alternative forms of organizing these industries to provide a greater share of benefits to the producers.

The analysis of existing institutional and political constraints to change is much newer. Our major initiative in this area is a small network being planned for 1986. It will look at the process of economic restructuring in four S.E. Asian countries and attempt to suggest, not only policy measures, but also ways in which policy reform can be implemented. The researchers will model the effects of alternative policy instruments on various interest groups to see which instruments are most feasible politically. It may be possible to select instruments with equivalent objectives which have less severe, less sudden or less visible effects on vested interests. The costs and benefits for specific groups will be modelled and compensation schemes devised for the losers.

A workshop and literature review of parallel markets in Africa is also being planned and will be partially financed by the next phase of the East Africa macro network. Farther down the road, we are thinking about a workshop on Macroeconomics and Agriculture in Africa, in order to help close the rift I mentioned earlier (micro/macro). One of the problems of economic research in many countries, particularly in Africa, is that macroeconomists have their finger on many of the important problems but have no data and are unwilling to leave their offices to collect it. Agricultural economists are willing to dig up micro level data but often investigate problems of a relatively trivial or locality-specific nature for lack of an understanding of the macroeconomic policy environment within which agriculture is situated. The workshop will bring both groups together and sensitize them to the contributions possible from the other's approach.

Implications for IDRC's role, its relationship to the research community and its impact on public policy

A basic question about this type of research, particularly on the political impediments to policy reform, is whether it is a legitimate field of support for IDRC. Are we or the researchers we support meddling in the politics of independent countries? To some extent, yes. It should be recognized, however, that all economic policy research has this aspect. Any significant change in economic policy will affect a country's income distribution, whether the policy analysts responsible acknowledge it or not. Value judgements and an acceptance of the existing rules of the game underlie even the most technocratic recommendations. Furthermore, the apparently neutral recommendations made by powerful foreign advisors inevitably have a destabilizing effect; by refusing to take their analysis a step further and suggesting how policy reform can be implemented, they fail to restabilize the situation.⁷

What are the implications of this approach for IDRC's relationship with the research community? The dichotomy between directiveness and responsiveness has been with us since IDRC began and is unlikely to ever be fully resolved. I believe the proposal I've outlined permits a reasonable balance between these conflicting objectives. What I've described is an approach to the study of development more than it is a specific set of problems. Researchers should continue to play the major role in defining research problems, since they are closest to the real world problems. IDRC, however, has the advantage of a comparative perspective and access to recent literature which researchers are often unaware of. Since IDRC staff work within an interdisciplinary environment and have the means to set up research networks, we are in a particularly good position to encourage comparative research on institutional questions.

Is this type of research feasible in the political conditions of many developing countries? We won't know until we try. In the Philippines we've had quite a bit of success working in sensitive areas on sensitive topics. In other areas it might be different. Research on local public finance should not be too difficult. Research on political impediments to change might be tricky, but the very premise of the research indicates it should be possible. Institutional analysis indicates that governments and bureaucracies are not monolithic and that it may well be in someone's individual interest to divulge sensitive information.

The question of the interest and training of researchers is also a serious one. The program I've described would be working on the research frontier, which is where I believe IDRC should be as much as possible. It will be difficult to work in this area, in part because developed countries have little intellectual technology to transfer - conventional economics as

taught in most North American universities doesn't have a lot to offer. On the other hand, developing country researchers should have a comparative advantage in this type of research because it doesn't require elaborate technical skills or theoretical training. Instead, the approach relies on sensitivity, common sense, and knowledge of local conditions. The local knowledge of local researchers and the comparative perspective made possible by IDRC networking should be a good combination.

Finally, what is the potential policy impact of all this? On some subjects, local public finance, for example, it should be quite direct and immediate. Governments are looking quite hard for alternatives to centrally-financed services and the poor themselves can be users of the information generated. Research on how to implement policy reform should also be useful to some governments, more useful than ivory tower research that points out inefficiencies but doesn't say in politically realistic terms how they can be eliminated.

Research of this type can also have policy impact at another level. It can generate ideas and public debate. Impact of a purely instrumental nature is not the only way that research can bring about change. History shows that ideas can be very powerful. Dependency theory had a tremendous influence on Latin American policy makers and led directly to the wave of import substitution that transformed the continent's economic structure in the fifties and sixties. The subsequent implementation of neo liberal policies had equally far reaching effects and was also strongly influenced by the intellectual currents of the day. In both cases, ideas took root in an environment and a time when policy makers were receptive to them. Developing countries have now acknowledged the need for structural adjustment and they have a broad picture of what their economies should look like. They and powerful agencies like the IMF and the World Bank are poised on the research frontier, waiting for ideas about how the restructuring process can be implemented. It is time for our researchers to supply these ideas.

Notes

1. This paper draws on a variety of sources, including ideas presented by IDRC Economics program members, participants at IDRC-sponsored workshops on Income Distribution and the Policy Process (October 1984) and Economic Adaptation and Structural Change (March 1985) and recent writing by Robert Bates and Lester Thurow. The paper reflects my personal opinions; its purpose is to provoke discussion rather than to provide a careful scholarly argument. Many sweeping generalizations are made which would be qualified in a more formal presentation. The paper has no specific regional focus, though it reflects to a large extent my recent thinking about Africa.
2. This phrase was suggested by Tyler Biggs at the 1983 meeting of the West African Association of Agricultural Economists.
3. Some of these criticisms are made by Lester Thurow in Dangerous Currents, 1983.
4. The example is taken from Thurow.
5. Richard Heaver, 'Bureaucratic Politics and Incentives in the Management of Rural Development'. World Bank Staff Working Paper #537. 1982.
6. Robert Bates, Essays on the Political Economy of Rural Africa. Cambridge.
7. David Leonard, 'What is Rational when Rationality Isn't' in Rural Africana #19-20 (Spring-Fall, 1984).